United States Court of Appeals

for the Second Circuit

BRIEF FOR APPELLANT

76-4199

Docket No.

UNITED STATES COURT OF APPEALS for the
SECOND CIRCUIT

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ANGELO J. and IDA A. BIANCHI,

Petitioners-Appellants,

v.

COMMISSIONER OF INTERNAL REVENUE,

Respondent-Appellee.

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P/S

BRIEF FOR PETITIONERS-APPELLANTS

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Preliminary Statement

The taxpayers herein are Dr. and Mrs. Angelo J. Bianchi, who filed a joint Federal income-tax return for their calendar and tax year 1970. Mrs. Bianchi is included simply because she signed the joint return: all of the income, etc. reported arose from the activities and property of Dr. Bianchi, a dentist. We shall accordingly in the interests of simplicity refer to Dr. Bianchi as the "Taxpayer".

(Items thought to be unnecessary have deliberately been omitted from the Appendix, for instance the order setting the place of trial, order extending the time to file briefs, etc. Also, as not essential, all Exhibits have deliberately been omitted: the evidentiary facts set forth in such Exhibits have all been properly found and are not in dispute.)

Taxpayer graduated from the Dental College of the University of Buffalo in 1949. (Stip., par. 11, p. 4, at App. 17.) Thereafter, in what is unusual for dentistry, he did an internship at the Eastman Dental Center in Rochester, New York, until 1950. (Ibid.) He did one year of private practice, then enrolled <u>full-time</u> for a one-year course in <u>general</u> anesthesia. (Stip., par. 12, p. 4, at App. 17.) Again, we leave it for the Court to conclude whether it is usual to have a doctor of dentistry who is fully qualified in <u>general</u> (not just dental) anesthesia. While Taxpayer continued his general practice of dentistry he administered general anesthesia at Mt. Morris Tuberculosis Hospital for 17 years. (Stip., par. 13, p. 4, App. 17.)

Taxpayer annually--for some 15 to 20 years past--attended the University of Buffalo Dental Seminars and participated in continuing education programs of the Rochester Dental Society. (Stip., par. 14, pp. 4 and 5, at App. 17f.) Additionally, he took courses in crown and bridge work and in implantology at the Institute of Graduate Dentists, New York City, New York. (Stip., par. 15, p. 5, at App. 18.)

In sum, Taxpayer is an unusually well educated dentist. (Tr. 53, lines 20, 21 App. 73 .)

His earnings from his practice of dentistry as a proprietor generally went up regularly from year to year, reflecting his greater skill and efficiency. In 1964 he earned only $47,620, while in 1969 he earned $75,702 and in 1970 $81,473. (Stip., par. 17, p. 5, at App. 18.)

On November 23, 1970, Taxpayer formed a professional corporation and conveyed his dental practice to it; all of the stock therein has at all times been owned by Taxpayer. (Stip., par. 3, p. 2, at App. 15 .) Such corporation duly elected Subchapter S status. (Stip., par. 4, p. 2, at App. 15f)

On November 24, 1970, the corporation duly adopted a pension plan which is concededly "qualified". (Stip., par.s 5 and 8, pp. 2 and 3, at App. 15f .) On November 30, 1970, the last day of its first short fiscal year, the corporation duly contributed $16,993.41 to the pension trust. (Stip., par.s 6 and 7, p. 3, at App. 16.)

From that $16,993.41 corporate contribution, $16,469.88 was allocable to fund Taxpayer's eventual retirement benefits, while the balance was to fund another employee's retirement benefits. (Stip. par. 21, p. 7, at App. 20 .)

The pension contribution and other expenses produced a net operating loss to the Subchapter S corporation of $16,946.11 for its year ended November 30, 1970 (Stip., par. 20, p. 6, at App. 19.), which the Taxpayer, as sole owner of the Subchpater S corporation, claimed as a loss in his income tax return for 1970.

However, the Commissioner in his Deficiency Notice (Sched. No. 3, App.10) claimed that the pension contribution, when added to direct compensation from the corporation for the first short fiscal year of $923.08 (Stip., par. 18, p. 6 at App. 19), was unreasonable and thus not fully deductible under Sec. 404. And the Commissioner cut back the allowable deduction to the corporation on a <u>per diem</u> basis, allowing thus 7/365ths of the otherwise actuarially determined

level annual deposit. This reduced the net operating loss deduction, per the Commissioner's Deficiency Notice, to a mere $278.59 (Ibid.). And, of course, this reduced the net operating loss Taxpayer was entitled to claim on his personal return to that same amount.

There was a half-day trial in Buffalo, New York, before the Hon. William A. Goffe, Judge of the U.S. Tax Court. As will be developed with particularity in the Argument part of this Brief, at trial the Taxpayer put on three witnesses: himself, an expert on pension plans, and an expert on the economics of the dental profession who was intimately familiar with dental economics in the Rochester area. The two experts were duly qualified. The Commissioner put on no witnesses whatsoever, and the Commissioner's cross-examination of the Taxpayer's witnesses did not attempt to discredit them nor to undermine the bases for their testimony.

Both experts testified, in substance, that the pension plan and contributions were "ordinary and necessary". The expert on compensation levels, etc. in dentistry testified that even were the entire pension contribution for 1970 added to the Taxpayer's compensation for all sources for the years 1964 through and inclusive of 1970, on a historical overall basis for that period the Taxpayer would not have been over-compensated but rather under-compensated. As noted, this testimony was not shaken or impeached, nor were any contradictory witnesses called by the Commissioner.

The main dispute revolves around two main issues: Was the pension contribution "unreasonable" within the meaning of Sections 404 and 162, so that part should be disallowed? And, in any event, did the Commissioner produce any evidence whatsoever to support the per diem allocation and disallowance set forth in his Deficiency Notice, or, rather, did he simply pull this out of thin air, without support at law or on the evidence?

A final issue involves whether the negligence penalty should equitably be applied to the deficiency--if one is found--on the alleged "unreasonable compensation" issue. The Tax Court gave judgment for the Commissioner on all issues, its opinion being at 66 TC 324 (1976) (App. 79).

Point I - The Tax Court's Finding of Fact that the Pension Contribution, When Added to Direct Compensation, Was "Unreasonable" Is "Clearly Erroneous".

At p. 19 of its Opinion (App. 97), the Tax Court found: "On its face, the $16,469.88 deferred compensation payment covering a 7-day period was unreasonable".

But the Tax Court does not advert--because it cannot--to <u>any</u> evidence whatsoever in support of such finding of fact.

The Tax Court went on (App. 97) to note the setlled law of <u>Lucas v. Ox Fibre Bruch Company</u>, 281 US 115 (1930), that compensation need not be in respect simply of the year in which it is coincidentally paid, but may be partially in respect of <u>prior</u> years which were undercompensated.

The Tax Court held as a matter of law that, unless there is some tax rule to the contrary, prior earnings as a self-proprietor could properly be taken into account when deciding whether overall compensation for a period of prior years had been low, so that a payment in a later year, by a corporate successor to the self-proprietor, as here, which might appear on its face to be "unreasonable", would be "reasonable" payment in the context of the low earnings of the prior period. (Opinion, pp. 16 and 17, App.94f).

Thereafter the Tax Court, admittedly, went on to rule that there <u>was</u> a rule of tax law forbidding taking into account undercompensation while working for a <u>predecessor</u> to the corporate employer making the payment. Necessarily, we humbly submit that there is no such rule of law: that is our Point II.

But for the time being we are only going to deal with that one finding of fact--that the pension contribution allocable to the Taxpayer, when added to his other direct remuneration from the corporate employer, constituted "unreasonable compensation".

The settled standard for considering on appeal a disputed issue of fact is whether the Court of Appeals is persuaded that the court below was "clearly erroneous" in making that finding of fact.

Admittedly, the findings of fact of the Commissioner are presumptively correct and the taxpayer--and the Taxpayer herein--have the burden of proof on each factual issue. But that might better be stated as that the taxpayer has the burden of going forward with <u>some</u> credible evidence on the fact in issue. And if the taxpayer does that, then it becomes the burden of the Commissioner to introduce some evidence rebutting or explaining or otherwise shifting back to the taxpayer the burden of going forward further.

In the instant case <u>all</u> the evidence--the undisputed, unimpeached, unrebutted testimony--was that both the pension plan and the pension contribution in issue were "ordinary and necessary" and that the compensation of the Taxpayer, even when the pension contribution allocable to him was added to him was added to direct remuneration, on an overall historical basis was not high, but rather low.

By way of example, P. J. Cichanowicz, CLU, the expert on pensions, characterized the benefits of the plan in issue as "quite average". (Trans. 37, App. 57). When asked, "Do you find it (the pension plan) to be ordinary and necessary, appropriate, sound and a good business decision?", he answered: "Yes, indeed." (Tr. 37, App. 57 .) And he further testified that had he been in the Taxpayer's shoes he would have adopted "the same pension program". (Ibid.) And that he would have put in the same corporate pension contribution. (Tr. pp. 37 and 38, App. 57f .)

And further, that such pension contribution was "required by the terms of the plan" and was "appropriate as a matter of sound pension administration". (Tr. 41, App. 61 .)

Mr. Chichanowicz further testified that "...economically a part of the pension contribution is attributable to past service normally". (Tr. 43, App. 63 .)

The expert on dental economics in the Rochester, New York, area, Peter A. Carillo, D.D.S., after having been qualified as an expert, was asked (Tr. pp. 53 - 54, App. 73f): "Well, Doctor, have you read the Stipulation of Facts in this case, and do you understand the data set down?

A. "Yes.

Q. "And, by the way, if you don't--if you want to refer to it, ask me to show it to you. Did you hear and pay attention to the testimony of Dr. Bianchi and Mr. Cichanowicz on the stand?

A. "Yes.

Q. "Based on such evidence of the two witnesses that preceded you, and of the stip--stipulation--, which is hard evidence, and your knowledge of the economics of the profession, how would you characterize Dr. Bianchi's earnings since 1964 and 1974 in the context of his training, education and skill? His historical earnings.

A. "Actually, I was surprised because I thought it was kind of low. Because Dr. Bianchi has an awful lot of training that some men don't have.

Q. "Now, you'll notice that we broke out the pension contributions allocable to his account for the years 1970 and '74. If--and we don't concede that it should be done--but, if you assume for a moment that you should add these pension contributions to his direct earnings, his salary from the corporation for those years in issue, 1970 through and inclusive of '74, would your prior answer be changed?

A. "No, I think he still would be definitely undercompensated.

Q. "And, now I'm going to go back to a shorter period. Going back, and it's the only matter immediately in issue--going back to all facts through December 31, 1970, and adding to his compensation that was set out from 1964, and even if you add the nearly $17,000.00 pension contribution in dispute to that, as of December 31, 1970, would your answer be the same? Through such period was he over, under--

A. "Yes, I think so. Yes--I think so.

Q. "How would you characterize it? His compensation on a historical basis?

A. "I'd say less than average."

As to the plan itself and contributions to it being "ordinary and necessary," Dr. Carillo responded to this question: "Are you familar with the pensions of incorporated dental practices in the Rochester area?", by saying: "Yes" (Tr. 54, App. 74 .) Then followed this testimony (Tr. pp. 54 and 55, App. 74f .):

Q. "You've heard the pension described, you've seen the stip--did you take a look at the 4462?

A. "Yes.

Q. "Okay. How would you characterize the pension in issue here, and as the amount of the benefits projected, to the average of the pensions with which you're familiar--those of incorporated practices in the Rochester area--in size of benefit?

A. "I'd say less than average.

Q. "In your opinion, as a student of this dental economics, was the pension adopted appropriate to this sort of a dental corporation? Let me break in. If mentally I could pick you up and put you into Dr. Bianchi's skin, back in November of 1970, as a good businessman--you're a practitioner of the healing arts, but you're also a businessman--as a sound business matter, would you have adopted the pension he adopted?

A. "No question about it.

Q. "And made the contribution that he made?

A. "Certainly."

The cross examination by the Government was fitful and inconclusive. It did not attempt to undermine any of the expert's conclusions, to challege his credentials nor the bases for his conclusions.

Accordingly, when the only testimony has been that the plan and contribution were "ordinary and necessary" and that the overall compensation of Taxpayer, even, ad arguendo , including the pension contribution, for the years 1964 through and inclusive of 1970 was not excessive or "unreasonable" but was rather "less than average", and when such testimony is fully credible and has not been rebutted or impeached, when the Commissioner has introduced not one iota of evidence on this issue, credible or otherwise, surely at such a point the Taxpayer has satisfied his burden of proof--or at least burden of going forward--and thus it is "clearly erroneous" for the Tax Court to have made a finding of fact that there was "unreasonable compensation".

We don't want to turn this into a "Federal case" as it were by over-exhaustive citation of authority. But here is some:

As was stated at the end of Mayson Manufacturing Company v. Comm'r, 178 F2d 115, 49-2 USTC 9467 (CA-6, 1949), rev'g and remanding 7 TCM 849:

> This is another case , similar to others referred to herein, where all the testimony before the Tax Court was on behalf of the petitioner. The Commissioner introduced no witness in his behalf. No witness testified that the compensation fixed by the Tax Court for each of the three officers was in fact reasonable compensation for the services rendered. We do not know from the record how those figures were arrived at. On the contrary, petitioner's testimony was that the compensation actually paid was reasonable compensation in each instance. No opportunity was afforded petitioner to cross-examine any witness who might have testified for the respondent to the contrary or to test the correctness or fairness of the figures selected by the respondent and the Tax Court. As was pointed out in T.P. Taylor & Co. v. Glenn, 62 Fed. Supp. 495, 499 (W. D. Ky.) (45-2 USTC 9410),--"If the compensation received....was

unreasonable for the services rendered, certainly the Government could have produced some experienced witness...who would have said so. The lack of such evidence operates very strongly against the defendant's contention." The case presents a situation very similar to those considered and discussed by this Court in Capitol - Barg Dry Cleaning Co. v. Commissioner, supra; Wright-Bernet v. Commissioner, Supra; Roth Office Equipment Co. v. Gallagher, Supra. We recognize that in the present case petitioner's evidence on the issue was not from impartial witnesses. But, nevertheless, it was uncontradicted and was not referred to in the opinion of the Tax Court as being unworthy of belief. Under such circumstances, the failure of the Commissioner to introduce testimony supporting the deductions made by him lends considerable support to our view, gathered from other undisputed facts in the case, that the findings of the Tax Court on the issues involved are clearly erroneous and should be set aside.

To like effect is Lockwood Realty Co. v. Comm'r, 264 F2d 241, 59-1 USTC 9307 (CA-6 1959), rev'g and remanding 17 TCM 247. And as was observed in Roth Office Equipment Co. v. Gallagher, 172, F2d 452, 49-1 USTC 9165 (CA-6 1949):

We are of the opinion that the findings of the District Court on the issue of the reasonableness of the compensation for 1942 were clearly erroneous and should be set aside. There was little, if any, dispute in the evidence. The appellee offered no witness in support of his position. No witness testified that the amounts found by the District Court as reasonable compensation in 1942 was the reasonable compensation to which the officers were entitled. The only direct evidence before the Court on the specific question of reasonableness of compensation was the testimony of Harold Hampton and Archie Shearer, both well-qualified, impartial witnesses, with many years of experience. They testified that in their opinion the compensation was reasonable, with Mr. Hampton referring to it as "very reasonable". The credibility of these witnesses was not put in issue. The appellee offered no witness to contradict this compensation was unreasonable to any extent. On this crucial and single issue of fact in this case this unimpeached, uncontradicted testimony from well-qualified, impartial witnesses can not be disregarded by the Court. This Court has several times stated that such testimony should be accepted by the fact-finder in a matter in which the fact-finder has no knowledge or experience upon which he could exercise an independent judgment. Capitol-Barg Dry Cleaning Co. v. Comm'r, 131 Fed. (2) 712, 715 (42-2 USTC 9785); Toledo Grain & Milling Co. v. Comm'r, 62 Fed (2) 171, 173 (1932 CCH 9580). See Lawton v. Comm'r, 164 Fed. (2) 380, 384 (47-2 USTC 9392); Weizer v. Comm'r, 165 Fed. (2) 772, 775 (48-1 USTC 9155). As was pointed out in T. P. Taylor Company v. Glenn, 62 Fed. Supp. 495, 499 (45-2 USTC 9410), W. D. Ky., if the compensation paid is unreasonable the appellee certainly could have produced some experienced witness from the industry who would have said so, and the failure to offer such a witness on the crucial issue in the case operates very strongly against his contention. The burden of proof in cases of this kind is upon the taxpayer, but we are of the opinion

> that burden has been met when the taxpayer introduces uncontradicted, unimpeached testimony from well-qualified, impartial witnesses sustaining its contention, unless the established facts themselves are such as to show that such testimony ought not to be accepted. Heywood Boot & Shoe Company v. Commissioner, 76 Fed. (2) 586 (35-1 USTC 9283), C. C. A. 1st.

As was noted in Capitol-Barg Dry Cleaning Company v. Commissioner, 131 F2d 712, 42-2 USTC 9785 (CA-6 1942), rev'g BTA memo. dec. CCH Dec. 11, 842-F, June 2, 1941:

> However, the testimony of (two impartial experts as to compensation) must be viewed in a different light. Their competency was not questioned. Their integrity was not attacked. They were not discredited in any manner, known to the law and no color, bias, prejudice or self-interest appears in their testimoany. Their testimony was unimpeached and should have been accepted by the Board in a matter in which the Board itself had no knowledge or experience upon which it could exercise an independent judgment. (Citing four cases.)

To like effect is Wright Bernet, Inc. v. Commissioner, 172 F2d 343, 49-1 USTC 9154 (CA-6 1949).

Of course, as was observed in F. M. Cullers v. Commissioner, 237 F2d 611, 615, 56-2 USTC 11, 647 (CA-8 1956): "The trier of facts under proper circumstances may reject expert testimony and reach a conclusion based upon its own knowledge, experience and judgment. However, it must fairly appear from the record that the fact finder had knowledge and experience relative to the subject matter. The expert opinion can not be arbitrarily disregarded. (Citing four cases, plus Mertens, Vol. 9, Sec. 50.62)

In the instant case it can hardly be urged that the esteemed court was familiar with economics of the dental profession in Rochester, New York, so that it might properly substitute its own "knowledge, experience, and judgment" for that of Peter A. Carillo, D.D.S., President of the Monroe County Dental Society, with a long list or credentials and experience (Tr. 51f, App. .) In any event, if the Tax Court had any such expertise, it failed to spread such expertise upon the record so that it could fairly be evaluated on appeal.

For purposes of this appeal we must assume the learned court below had no particular competence in this area when it determined as a factual matter that no more than 7/365ths of the pension contribution allocable to Taxpayer could be added to his direct corporate compensation without such (supposed) overall compensation becoming "unreasonable compensation".

Apparently, 8/365ths of such amount when added to otherwise direct compensation would be "unreasonable" to the extent of 1/365th? Why? What rule, what evidence was there for the allocation on a per diem basis? The expert on pensions generally, P. J. Cichanowicz, CLU, testified abundantly that a full level annual contribution was both required and appropriate and that the Commissioner's attempted proration was, in substance, ridiculous. (Tr., 27-30 , App.47-50.) There is no evidence whatsoever for the magic amount pulled, with all due respect to the esteemed Tax Court, "out of the blue".

Accordingly, on the settled law so abundantly cited, it is submitted that the Tax Court's finding of fact on the "unreasonable compensation" issue is "clearly erroneous" and ought to be reversed.

Point II - A Successor Corporation to an Unincorporated Trade or Business May Properly Pay and Deduct Expenses Economically Attributable to the Pre-Incorporation Period

The Tax Court really "ducked" extensive discussion of our Point I, above (which would have probably revealed to the Tax Court its error), because it opined that another principle of tax law would, despite the settled rule of Lucas v. Ox Fibre Brush Company, in any event would bar Taxpayer's corporation from paying and deducting as "reasonable compensation" any amount attributable to services performed in the pre-incorporation period.

It first adverted to Burnet v. Clark, 287 US 410 (1932) and Dalton v. Bowers, 287 US 404 (1932) as supporting the "separateness of difference taxable entities". No one can object to those cases. But they apply to a different situation:

where the individual taxpayer is seeking to ignore the separateness of a corporation he has formed and used and to claim its deductions and losses as his own. Plainly, that cannot be done, but it simply is not our case.

The one case the Tax Court cites as supposedly decisive is U.S. Asiatic Company v. Commissioner, 30 TC 1373, 1380 (1958). Admittedly, the case is troubling. It can be distinguished, on its facts, but the most forthright approach would be to declare that the rule of law proposed in its issue 1 is simply error and not going to be followed by this Court.

After all, the case is not a pillar of tax jurisprudence. In the eight years since it was decided, despite numerous decisions (hereafter to be adverted to) in this thorny area, it had only once been cited for its issue 1 until it was cited in the opinion below.

That one prior citation is in Wimbish, Jr. v. U.S., 267 F. Supp. 597, 67-1 USTC 9319 (Dist. Ct., W.D. Ky. 1967), where it was unsuccessfully urged by the Government as, by analogy, not permitting a taxpayer receiving a retirement pension from his last employer, an American company, to exclude about 75% of such pension payments as attributable to foreign service for the years 1924-1953 under then Sec. 911(a)(1) of the Code. In fact, a close study of Wimbish fairly suggests that the practical common-sense approach taken by the court therein is supportive of Taxpayer's position here.

Again, the U.S. Asiatic Co. holding on issue 1 does not cite one case, ruling or regulation as support for its radical view. It is a piece of jurisprudence seemingly sprung full grown from the head of Zeus.

In passing, the Tax Court mentions that the Government argued on brief that Underwriters Laboratories, Inc. v. Commissioner, 46 BTA 464 (1942) was authority for its position. We showed that case to be factually distinguishable in our reply brief below: it simply holds that when the predecessor actually paid the expense in issue, then the successor corporation may not claim a deduction for an item it admittedly did not pay. The Tax Court, apparently recognizing

this case as not in point, did not rely on it.

How can U.S. Asiatic Company be distinguished on the facts? It can be done, but, admittedly, with some difficulty. In such case the $3,000 in issue as salary to the sole proprietor for six months prior to incorporation was explicitly paid as salary at the rate of $500 per month for those six months. Admittedly, this is a formal matter: but the $3,000 was not claimed as compensation for the period after compensation which might appropriately be increased on the principle of Lucas v. Ox Fibre Brush Co., supra, on account of undercompensation prior to incorporation, as here.

Again, issue 2--the "thin incorporation" issue--is the most nearly celebrated one in the case. If was there held that the corporation (with but $1,000 capital) was plainly "thinly capitalized", so that interest in respect of such "debt" was disallowed.

The sole proprietor-sole stockholder therein had many unreimbursed expenses, too, which were a part of issue 1. The Tax Court might have alternatively concluded, as an aspect of issue 2, that the sole proprietor-sole stockholder had set over his claim for reimbursement of expenses and adequate compensation for the pre-incorporation period in return for stock: that these expenses on the facts of "thin incorporation" should be treated as capitalized. It did not do that explicitly, but it could have made this an alternative holding and may have been deemed to have done so, sub silentio.

In the instant case there was no suggestion of any "thin capitalization" issue, nor any factual holding in support of it.

But when all is said and done the better approach, we humbly suggest, is simply to recognize that judges are human and occasionally have a bad day and that not all their holding on the law are worthy or respect by a higher court: the holding on issue 1 in U.S. Asiatic Co. should be explicitly over-ruled.

What is our authority for our Point II? First, "Corporations---Assumption of Liabilities", 233-2 TM A-39: "A liability incurred by the transferee should

be deductible when paid even though it relates to the preacquisition conduct of the transferor's business," citing Joshua C. Kelley, 38 BTA 1292 (1938), acq., 1939-1 CB (part 1) 19.

And this very Court in the celebrated case of Bongiovanni v. Comm'r, 470 F2d 921, 925, 73-1, USTC 9133 (CA-2 1972), rev'g TC Memo. 1971-262, 30 TCM 1124, observed that the transferee corporation after a Sec. 351 incorporation would be entitled to deduct accounts payable attributable to the pre-incorporation period when paid, stating:

> It is no answer to say that the taxpayer's wholly-owned corporation will eventually reap a benefit which will redound to the appellant. The corporate taxpayer would be entitled to its deduction whether or not the cash basis individual taxpayer had been taxed under Section 357 (c). See Treas. Reg. Sec. 1.461-1(a)(2).

While the Bongiovanni case has been alternatively lauded and denounced by differing tax scholars, it remains law in this Circuit and is a refreshing, practical and common-sense approach to the intensely practical matter that is taxation.

The same Tax Management portfolio previously cited, 233-2 TM, concludes on this issue at p. A-40:

> Although not a published position, the Service has ruled for several years that liabilities assumed incident to the incorporation of a going business are deductible by the transferee on the theory that such treatment assumes a clear reflection of the income of the incorporated business. The cited cases, the Service's rulings position and at least two other decisions (citing cases) may indicate future formal recognition by the Commissioner of the appropriateness of such a deduction by the transferee.

We argued for this concept in our Reply Brief below, at pp. 8 -10. Since we believe the argument, although apparently rejected by the Tax Court, remains valid, we are reproducing those three pages at this point. (see next 3 pages.)

And what of Wimbish, Jr. supra , which we promised to discuss? In that case, as here, the Government raised a glorified quibble: the pension was paid by a U.S. employer, Brown & Williamson, in Lexington, Ky.

rulings does not making them any more nearly relevant.

At. p. 23-25, Respondent turns to an interesting idea: allowing taking into account prior service or prior under-remuneration would allow tax deductions to the "wrong" taxpayer: the successor corporation. It cites in support thereof two cases. But one of them, Underwriters Laboratories, Inc., 46 BTA 464 (1942), while often cited for this proposition, is really not in point.

In that case the predessor Illinois corporation paid an estimated premium for a group annuity as a pension plan of $463,144.36. But after the actuaries at the Equitable Life had done their homework, they discovered that the proper premium was $41,081.12 less. It was informally worked out that $39,497.36 of the otherwise reimbursement should be applied to buy additional annuity benefits. Thereafter the Delaware successor corporation was formed, the petitioner in that case. The Board of Tax Appeals correctly observed that the Delaware corporation plainly could not claim the $39,497.36 as its deduction since it did not pay the amount: the Illinois corporation did. There is no suggestion in the case that expenses should be allocated to the "proper" taxpayer. This was simply a factual matter: Which taxpayer had in fact paid the sum in issue?

And yet, let us concede some validity to the general rule: as a sound accounting, economic and tax matter ideally expenses should be grouped with and against the income such expenses produce.

But as with almost any rule there are exceptions. And probably the most notable has to do with a corporation formed in the tax-free incorporation of a trade or business. In such a case the corporation is treated much as

a continuation of the unincorporated "entity" that preceded it. That is the rationale underlying Sec. 351 of the Code, which we explored in a quote from Portland Oil Co. v. Comm'r at the bottom of p. 15 of our brief.

It would exalt form over substance not to view a corporation formed pursuant to Sec. 351,particulary a Subchapter S Corporation, as here;as a continuation of the unincorporated trade or business from which it was formed. It is now recognized that accounts receivable in a Sec. 351 transfer go over to the corporation tax-free. Kniffen v. Comm'r, 39 TC 553 (1962), Acq.

And while we used to have worries as to whether accounts payable could go over and properly be deductible by the successor, at the practical level the Service not only concedes this to be true, but insists upon it in closing agreements. That is, a taxpayer wishing a closing agreement that accounts receivable will go over in Sec. 351 incorporation and when collected be taxable only then to the corporation, must agree as part of that closing agreement that accounts payable will similarly go over and only be deductible by that corporation when paid. (We assume throughout a cash-basis taxpayer, as here.)

Benjamin, in his "Problems in Transitition from Sole Proporietorship or Partnership to Corporation", 26 NYU Institute on Federal Taxation (1968) at 805, 806, notes:

> "The carried-over business activities would seem to justify a carried-over ordinary and necessary concept. It may be this reasoning that has caused the Service to give private advance rulings allowing the deduction (of payables) to the successor corporation, at least if a closing agreement is entered into by the predecessor business specifying that it will not likewise

attempt to deduct the payables."

He cites the "most recent published statement of this position" in his footnote 65 as Points to Remember #1, Oct. 1965, ABA Bulletin of Tax Section. To like effect is Shenkin, "The Professional Corporation", from The Tax Adviser, as reprinted in The Monthly Digest of Tax Articles, June, 1970, at p. 74.

Again, we used to have a lot of worries over reserve accounts, like a reserve for bad debts, upon incorporation: Should the balance be "reversed" and treated as income to the predecessor upon incorporation? Estate of Heinz Schmidt, 355 F.2d 111 (CA-9 1966) reversed the Tax Court (42 T.C. 1130 (1964)) on this and looked to the realities of the exchange: the stock received only reflected the net value of the receivables and other assets transferred, necessarily net of any reasonable reserve for bad debts. And the Supreme Court decision in Nash v. U.S., 398 U.S.1(1970), finally ended this confusion in viewpoint.

In sum and without unduly prolonging this argument, we are increasingly regarding a Sec. 351 incorporation as not interrupting the economic and tax history of an entity but continuing it in a somewhat changed form: this is really the same business entity. That is the Congressional purpose underlying Sec. 351.

Accordingly, if payables can go over, why cannot past-service unfunded pension liabilities--which are themselves a sort of payable? Especially when the successor corporation is a Sub S corporation, as here, which has certain aspects similar to an unincorporated entity? As an ideal matter Dr. Bianchi would have installed a pension plan back when he first went into a dental practice. Unfortunately, without HR 10 at that time he couldn't. Thereafter, when he was made aware of the problem of retirement income he

Accordingly, argued the Government, since such pension cannot be a grauity, it <u>must</u> be <u>for</u> services performed for <u>such</u> employer, all of which services were concededly performed within the United States, so that Sec. 911(a)(1) would be inapplicable.

Come, come, said the court, that's overly formalistic and ignores the fact that all Wimbish's service had been for members of the British-American (tobacco) Group, pursuant to common employment and retirement policies, one of which obligated the final employer to pay the standard pension, and that his service for the years 1924-1953 plainly was a bona fide foreign resident, so as to qualify some 75% of the monthly payments as excludible under then Sec. 911(a)(1).

The cite to <u>U.S. Asiastic Co.</u>, <u>supra</u>, was brushed aside. Here the court recognized that a pension economically is recompense for <u>all</u> prior service for the "employer" in the largest sense. In <u>Wimbish</u> this included affiliated corporations within the term "employer". In <u>Bianchi</u> and any like case, we submit, such term should include any predecessor unincorporated trade or business.

Indeed, returning to the common-sense aspect of this question, what if a doctor, lawyer or CPA were to labor loyally and well for his clients or patients for some 40 years, and then in advanced years was to incorporate his practice and adopt a pension plan. If the Commissioner's position herein is correct, his corporation may only set up and deduct contributions to such plan which are economically attributable to his services performed in the few years <u>after</u> incorporation. But that is absurd: it would condemn him to a plainly inadequate pension level, since virtually all of his services were performed prior to incorporation. That cannot be the law in this "intensely practical matter that is taxation", unless the Code on its face fairly forces us to such a conclusion. We submit that nowhere in the Code is there any barring of a carried-over "ordinary and necessary" concept on the facts of this case and like cases.

Indeed, the Tax Court was on the right track in certain of its colloquy reflected in the Transcript. At Transcript p. 50 (App. 70), in overruling the Government's objection that Peter A. Carillo, D.D.S., should not be considered an expert witness on compensation of incorporated dental practices if he based part of his conclusions on experience with unincorporated practices, the Tax Court observed:

> Well, I think you're getting to the heart of the reasons that your argument doesn't make any sense. If it's a Subchapter S corporation, the income is all going to be taxable to the shareholder anyway. If it isn't, it isn't. It's probably a personal holding company then. I'll overrule the objection and permit the witness to testify.

In our Brief below we showed how the rule advocated by the Government and embraced by the Tax Court would lead to absurd, unreasonable and unjust results: how taxpayers economically situated identically would be treated radically different. We argued via a somewhat lengthy hypothetical that "equity and reason fairly cry out that both of these hard-working taxpayers should be treated identically"--and so should Dr. Bianchi herein. And that the only way to do that is to adopt a rule permitting taking into account preincorporation services when measuring later amounts paid for "reasonable compensation". We here set out page 17 from our Brief below, <u>in extenso</u>, ending however, at out point 5 therein. (See next page.)

And, finally, what of <u>R. J. Nicholl Co. v. Comm'r</u>, 59 TC 37 (1972)? That case, the Tax Court said,had facts "clearly and significantly distinguishable" (Op. 20, App. 98). Really? Every case is <u>some</u>what distinguishable from another. The question is are the distinctions sufficient to justify a difference in legal result?

Basically, what the Tax Court did in failing to see that the instant case is fully in point with <u>R. J. Nicholl Co.</u> was to fail to respect human capital as being fully as vital as physical capital.

In <u>R. J. Nicholl Co.</u> the taxpayer's president deliberately undercompensated himself in order to build up the net worth of the corporation's predecessor, to

It may be objected that we are expanding the rule of *Lucas v. Ox Fibre Brush Co.* to consider undercompensation in years prior to the incorporation of the business involved. Admittedly, we are, along the lines we have previously argued: that economic realities should count, not formal changes in the way of owning a business.

Assume two men have started virtually identical businesses: one in Massachusetts, one in California. The Californian incorporates his business from its inception -- possibly under Subchapter S. The Massachusetts taxpayer does not. Assume that this particular business requires a lot of building, long hours of work and does not yield much revenue for many years. Assume, indeed, that in each case, it has losses for the first three years aggregating $50,000 and requires further capital contributions.

But in the fourth year and thereafter it zooms in profitability. At this point the Massachusetts taxpayer finally incorporates. Deciding that his long years of unpaid service justify a higher than usual salary he fixes it at $72,000. Coincidentally, so does the Californian. Let it be stipulated that the Californian's compensation is reasonable only when past non-compensation for three years is taken into account. But that if the first three years of no earnings cannot be taken into account it is $22,000 excessive: that much is "unreasonable" and non-deductible under Sec. 162.

The problem is that apparently for the Massachusetts taxpayer in the indentical economic position we cannot -- according to the Service -- take into account his low (or here, no) remuneration for years predating the actual incorporation. Accordingly, by hypothesis he has $22,000 of excessive, "unreasonable" and non-deductible compensation.

Can this really be the intended effect of our tax law? We have enough anomalies and arbitrary aspects of the Code without engrafting this attempted foolishness upon it.

Equity and reason fairly cry out that both of these hard-working taxpayers should be treated identically (unless the Code inescapably *requires* another result -- which it does not). And the only way to reach that fair end is to take into account earnings from years prior to incorporation for the Massachusetts taxpayer.

If this is done for the Massachusetts taxpayer of our hypothetical, so, too, should it be done for Dr. Bianchi.

~~Point 5 The annual level deposit method of funding a pension used in the instant case is not alone an acceptable method, it is the most commonly used and is explicitly sanctioned by IRS publications and IRS plan reporting forms going back to the early 1940's. There is no authority whatsoever for reducing an otherwise level annual deposit in a short fiscal year.~~

~~We have asked for a finding of fact (14) on this same issue. Frankly, we're not sure whether it is a question of fact or of law. Maybe, indeed, it is a mixed question of law and fact.~~

expand, to produce the net worth on which to borrow so as to acquire land and build more gasoline filling stations. Fine, that is how physical capital is built up, at the expense of current compensation in those earlier years. Any deferred consumption creates physical capital. And it is only appropriate in later years that the person who has sacrificed to build up that trade or business, whether or not the mere form of such trade or business has been changed, should be entitled to additional compensation reflecting the earlier years when he took little pay. That is what R. J. Nicholl Co. holds, in an eminently sensible decision.

But what of human capital? This year we celebrate the 200th birthday of the Republic. But in that same birth year, 1776, another seminal work sprang alive: Adam Smith published his Wealth of Nations. And therein we read:

> The acquisition of such talents, by the maintenance of the acquirer during his education, study, or apprenticeship always costs a real expense, which is a capital fixed and realized, as it were, in his person. Those talents as they make a part of his fortune, so do they likewise of that of the society to which he belongs.

In sum, Adam Smith reminds us that when Dr. Bianchi went to college and then dental school and then did a full-time dental internship and then, while necessarily conducting his dental practice on a reduced scale, did a full-time course in general anesthesia, when he attended the annual University of Buffalo Dental Seminars for some 15 to 20 years, when he took a course in crown and bridge work and in implantology at New York City's Institute of Graduate Dentists--when Taxpayer did all of this he was creating "human capital": capital "fixed and realized, as it were, in his person".

Necessarily, all of this creation of human capital "cost a real expense" in the maintenance of Dr. Bianchi"during his education, study or apprenticeship"--both for current living expenses and in terms of giving up time for education which could have otherwise been used to serve patients and produce fees.

Dr. Peter A. Carillo testified (Tr. 53, App.   ), that Dr. Bianchi "...has an awful lot of training some men don't have."

When this training has paid off in increased skills, effi[illegible]ncy, higher billings, etc., as in the instant case, is not the former single practitioner allowed to take additional compensation in respect of the long years of his formal education and training during which he was plainly undercompensated, <u>because</u> he was spending time and money on his education? And does not <u>Lucas v. Ox Fibre Brush Co., supra</u>, hold that if over-all historical compensation for the entire period is "reasonable", the coincidence that "catch-up" compensation is paid later will not result in a disallowance under today's Sec. 162(a)(1)?

We feel that <u>R. J. Nicholl Co.</u> states good law and is fully applicable here.

Point III -- Despite the Seemingly Overwhelming Jurisprudence to the Contrary, the Negligence Penalty Should Not Be Applied to That Part of a Deficiency Which Is Plainly <u>Not</u> Due to Negligence.

We concede that the learned court below properly stated what <u>appears</u> to be nearly settled jurisprudence: that if <u>any part</u> of a deficiency is due to negligence, then the 5% negligence penalty of Sec. 6653(a) is applicable to the <u>entire</u> deficiency, notwithstanding that most is <u>not</u> due to negligence.

This is so plainly unjust that we believe it is time for a respected court like this Court to say "Enough--we cannot suppose Congress to have enacted an arbitrary, unreasonable and unjust provision, a provision which would, for $1 of deficiency attributable to negligence, allow imposition of a 5% penalty on $1-million of the balance of the deficiency which balance all conceded was <u>not</u> due to negligence."

An alternative reading of the statute is possible: a reading at once fair, reasonable and just: only the portion of the deficiency attributable to negligence will be subject to the penalty.

Obviously, of course, if Taxpayer prevails on either of our Points I or II and no further deficiency is found, this Point III becomes moot.

CONCLUSION: For the reasons stated, we urge that it be held that--

I--The finding of the Tax Court below on the issue of "unreasonable compensation" is clearly erroneous and requires reversal.

II--A successor corporation to an unincorporated trade or business may properly pay and deduct compensation economically attributable to services performed for the same trade or business prior to incorporation, provided only that historical compensation from both sources is not "unreasonable".

III--The 5% negligence penalty is only to be imposed on that part of the deficiency attributable to negligence--

and that, accordingly, decision be given for Taxpayer on all issues.

Respectfully submitted,

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